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No. 01-397

IN THE

Supreme Court of the United States

SCHOLASTIC CORPORATION and
RAYMOND MARCHUK,

Petitioners,

v.

RICHARD TRUNCELLITO and
THE CITY OF PHILADELPHIA,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF

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STATEMENT PURSUANT TO RULE 29.6

Petitioner Scholastic Corporation's Rule 29.6 Statement was set forth at page iii of the Petition, and there are no amendments to that Statement.

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This case presents three entrenched circuit conflicts over the pleading standards established by Congress in the Private Securities Litigation Reform Act ("Reform Act"). Plaintiffs' effort to rationalize the circuits' competing tests is belied by numerous appellate and district court decisions that recognize the conflicts are real and outcome determinative. The Second Circuit's lenient standards have been rejected in whole or substantial part by at least *seven* circuits.[1] Other circuits repeatedly reach the opposite result on similar facts.

The current state of the law is unacceptable. It is directly contrary to Congress' undisputed intent to create "uniform and more stringent" standards for alleging securities fraud. H.R. Conf. Rep. No. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740. Congress found that abusive securities fraud complaints frequently survived motions to dismiss under prior law. As a result, plaintiffs were able to use the discovery process to drive up legal fees, disrupt the defendants' business, and extract a settlement regardless of the merits. Long-term investors ultimately bore these unnecessary costs. *Id.* at 31-32. In order to prevent this wasteful drain on the nation's economy, Congress strengthened the pleading standards to make it "substantively harder for plaintiffs to bring securities fraud cases." *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 196 n.9 (1st Cir. 1999). Congress directed courts to act as gatekeepers *at the pleading stage*, before discovery begins.

This case is the ideal vehicle for this Court to resolve the circuit conflicts over the Reform Act's pleading standards and to make uniform the more stringent standards that Congress intended. Plaintiffs' complaint is typical of the speculative, "fraud by hindsight" securities fraud claims frequently presented to district courts. Filed just weeks after Scholastic announced that sales of a key product had fallen, the complaint alleged, on

1. In addition to the decisions cited in the Petition, *see Florida St. Bd. of Admin. v. Green Tree Fin. Corp.*, Nos. 99-3536, 99-3586, 99-3587, 2001 U.S. App. LEXIS 22921 (8th Cir. Oct. 25, 2001); *Nathenson v. Zonagen, Inc.*, 267 F.3d 400 (5th Cir. 2001); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245 (10th Cir. 2001).

information and belief, that Scholastic should have disclosed an ambiguous sales "trend" earlier. Plaintiffs also alleged that a single executive sold Scholastic stock early in the purported class period. The district court twice granted Petitioners' motions to dismiss. The Second Circuit reinstated the complaint, not based on a subtle disagreement about Plaintiffs' allegations, but because it decided that "plaintiffs were held to a more stringent standard than the law requires." Pet. App. 11a. In other words, the choice between competing legal standards under the Reform Act is outcome determinative in this case.

ARGUMENT

The Reform Act requires Plaintiffs to specify the circumstances that constitute the alleged fraud, set forth all facts that support allegations pled on information and belief, and plead with particularity facts that create a strong inference that each defendant acted with fraudulent intent. 15 U.S.C. § 78u-4(b)(1)-(2). In direct conflict with most other circuits, the Second Circuit held Plaintiffs to none of the Reform Act's requirements.[2]

I. This Case Is The Appropriate Vehicle To Resolve The Circuit Split Over The "Motive And Opportunity" Test

Contrary to Plaintiffs' claim that "there is no conflict among the Circuits" (BIO 22), the courts of appeals have repeatedly recognized that they are split on whether "motive and opportunity" allegations are sufficient to establish a "strong inference" of scienter. *See, e.g.*, *Fleming*, 264 F.3d at 1261 ("The courts of appeals are currently split on the question of whether plaintiffs may still use 'motive and opportunity' pleadings to demonstrate scienter under the heightened pleading requirements set forth in the PSLRA."); *Zonagen*, 267 F.3d at 410 ("The Courts of Appeals are divided . . . over the status of the motive and opportunity method.").

The Second Circuit applied a permissive rule based on its own pre-Reform Act case law: Plaintiffs can plead scienter

2. Petitioners are not barred from raising these circuit conflicts. *Contra* BIO 19-20. In the proceedings below, Petitioners were bound by Second Circuit precedent. Also, Petitioners specifically argued that the Second Circuit's standards were too lenient. *See* Petrs. C.A. Br. 32.

by "alleging facts demonstrating that defendants had both the motive and opportunity to commit fraud." Pet. App. 19a. The court found Plaintiffs had satisfied their pleading burden solely by alleging that Marchuk had access to inside information and sold 80% of his Scholastic stock early in the alleged class period. *Id.* 19a-23a. By accepting such bare "motive and opportunity" allegations alone, the Second Circuit never considered whether these allegations actually created a "strong inference" that Marchuk acted with fraudulent intent.[3]

There are two distinct circuit conflicts on this issue. The Ninth Circuit takes the strict view that "motive and opportunity" allegations can never establish a strong inference of scienter. *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 977-79 (9th Cir. 1999). Indeed, the principal case cited by Plaintiffs acknowledged that the legal standards applied by the Second and Ninth Circuits cannot be reconciled. *Green Tree*, 2001 U.S. App. LEXIS 22921, at *35-36.

Ronconi v. Larkin, 253 F.3d 423 (9th Cir. 2001), a decision that Plaintiffs do not seriously attempt to distinguish (BIO 24), illustrates that the Ninth Circuit would reject Plaintiffs' "motive and opportunity" allegations. *Ronconi* affirmed the dismissal of a complaint alleging that an executive vice president sold 98% of her stock during the class period. The court found that this trading, viewed in context, "supports only a weak inference, not a strong one, in light of what the other, equally knowledgeable, insiders were doing." *Id.* at 436. Plaintiffs here did not allege that any other Scholastic officer or director had

3. Plaintiffs argue that "the allegations against Marchuk were not based solely on motive and opportunity." BIO 26 & n.23. Each allegation they cite, however, either (i) goes to whether Marchuk had a "motive and opportunity" to engage in fraud (*e.g.*, he had "access to internal Company data"), or (ii) involves an allegation against Scholastic generally, not Marchuk (*e.g.*, projected 20% sales growth was not "reasonable"). At most, Plaintiffs' argument highlights the difficulty of using "motive and opportunity" allegations in a case involving both individual defendants and corporate defendants (who can form "scienter" only through their employees).

engaged in suspicious trading. But in direct conflict with *Ronconi*, the Second Circuit held that "whether other Scholastic officials sold their stock prior to the February 20, 1997 press release" was "irrelevant." Pet. App. 21a.

The First, Fifth, Sixth, Tenth and Eleventh Circuits also reject the Second Circuit's "motive and opportunity" analysis. These courts have all held that allegations of motive and opportunity may be relevant when analyzing a defendant's state of mind, but "do not constitute a separate, alternative method of pleading scienter." *Fleming*, 264 F.3d at 1261 (citing cases). These courts view "motive and opportunity" allegations only as "an analytical device for assessing the logical strength of the inferences arising from particularized facts pled by a plaintiff." *Zonagen,* 267 F.3d at 411. Such allegations "are typically not sufficient in themselves to establish a 'strong inference' of scienter." *Fleming*, 264 F.3d at 1262. In this case, Plaintiffs have not alleged any unusual facts that would support an exception to the general rule in these circuits.[4]

Indeed, other circuits have held that similar allegations do not create a strong inference of fraudulent intent. Plaintiffs here claimed that a single vice president sold shares worth $1.2 million early in the class period, before Merrill Lynch issued an allegedly manipulated report that upgraded the Company. Pet. App. 41a; 56a. In *FTP Software*, the First Circuit affirmed the dismissal of a complaint that alleged that three executives, including the chief executive officer and chief financial officer, sold a total of $23 million in stock during the class period. 194 F.3d at 206-07. The court found the fact that "[e]ach sold some stock before an allegedly manipulated analyst's report. . . . recommended FTP stock as a long-term buy" refuted any inference of fraud. *Id.*; *see Zonagen*,

4. Plaintiffs are wrong to claim that the "First Circuit concluded that it was in agreement, not disagreement, with the Second Circuit as well as the Third and Fifth Circuits on this issue." BIO 23. In reality, the First Circuit held: "[T]his court has never adopted the Second Circuit test. Instead, we have analyzed the particular facts alleged in each individual case to determine whether the allegations were sufficient to support scienter." *FTP Software,* 194 F.3d at 196.

267 F.3d at 420 (allegation one director sold $1.9 million of stock did not create strong inference of fraud).[5]

II. This Case Is The Appropriate Vehicle To Resolve The Circuit Split Over What Constitutes A "Strong Inference" That Defendants Acted With Scienter

Section (b)(2) requires that courts must be able to draw a strong inference of scienter in order to sustain a securities fraud complaint. Unlike claims governed by Rule 12(b)(6), "the 'strong inference' requirement means that plaintiffs are entitled only to the most plausible of competing inferences." *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir.) (*en banc*), *petition for cert. filed* (U.S. Sept. 27, 2001) (No. 01-538). As the First Circuit explained in *FTP Software*:

> Congress has effectively mandated a special standard for measuring whether allegations of scienter survive a motion to dismiss. While under Rule 12(b)(6) all inferences must be drawn in plaintiffs' favor, inferences of scienter do not survive if they are merely reasonable, as is true when pleadings for other causes of action are tested by motion to dismiss under Rule 12(b)(6). Rather, inferences of scienter survive a motion to dismiss only if they are both reasonable and "*strong*" inferences.

194 F.3d at 195-96 (citations omitted; emphasis in original).

5. For the reasons discussed in the text, the Eighth Circuit's attempt to reconcile the Second Circuit's decisions with those of the First, Fifth, Sixth, Tenth and Eleventh Circuits, *see Green Tree*, 2001 U.S. App. LEXIS 22921, at *37-40, rests on an unpersuasive reinterpretation of Second Circuit case law. That the Second Circuit's standard is substantially more lenient than the Eighth Circuit supposed is illustrated perfectly by this case and by decisions of district courts in the Second Circuit, which do not require allegations of "motive and opportunity" to give rise to a "strong inference" of scienter. *See, e.g.*, *In re Complete Mgmt. Inc. Sec. Litig.*, 153 F. Supp. 2d 314, 328 (S.D.N.Y. 2001) ("plaintiff's burden on a motion to dismiss is to state [a] motive that, after taking all *reasonable inferences* in the plaintiff's favor, has a sufficient *reasonable possibility* . . . of developing proof that a motive in fact existed") (emphasis added; internal quotation marks omitted).

The Second Circuit refused to follow this statutory mandate. It did not evaluate whether the inferences from Plaintiffs' allegations were "strong" or "the most plausible." Instead, the court simply drew all "reasonable," and even "not unreasonable," inferences in Plaintiffs' favor. Pet. App. 8a, 14a, 17a, 24a. The district court, by contrast, applied a heightened standard and dismissed the complaint.[6]

The Second Circuit's acceptance of allegations that Scholastic engaged in "aggressive sales practices" highlights how its permissive standards conflict with those of other circuits. Pet. App. 16a, 24a. In *FTP Software*, the First Circuit rejected a nearly identical claim on the express ground that any inferences that could be drawn from such sales practices were weak, not strong. Plaintiffs there alleged that a company engaged in aggressive sales practices, which they called "channel stuffing," to shift income to an earlier period by inducing customers to accelerate their purchases. The First Circuit found "nothing inherently improper in pressing for sales to be made earlier than in the normal course." 194 F.3d at 202. The court noted that "channel stuffing" allegations may have "some probative value" as to management's knowledge of low revenues, but held "that value is weak." *Id.* at 203. According to the First Circuit, "there may be any number of legitimate reasons for attempting to

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6. There is no merit to Plaintiffs' claim that the Second Circuit used "'reasonableness' language only when discussing inferences involving elements of fraud (such as falsity and materiality) other than scienter." BIO 17. The court specifically referred to its "discussion in Sections IA and B" in support of its conclusion that, "[a]s to whether plaintiffs adequately pled an inference of scienter, we find they did." Pet. App. 24a. The court incorporated into its scienter analysis the "not unreasonable" inferences it drew with respect to the existence of an alleged negative trend. Thus, the Second Circuit did not simply cite the Rule 12(b)(6) standard at the opening of its decision only to later apply the Reform Act's "strong inference" requirement when analyzing Plaintiffs' scienter allegations.

achieve sales earlier. Thus, it does not support a strong inference of scienter." *Id.*[7]

The Second Circuit compounded its error by lowering the bar for pleading scienter to bare negligence. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197-201 (1976) (§ 10(b) "clearly connotes intentional misconduct"); *see also* Pet. 15 n.1. According to the court, "recklessness is adequately pled for defendants who knew or *should have known* they were misrepresenting material facts with respect to the corporate business." Pet. App. 23a (emphasis added). Applying this standard, the court found that Plaintiffs had "alleged enough to permit proofs that Scholastic *should have been alerted*" to a negative sales "trend." Pet. App. 18a (emphasis added). In *Fleming*, the Tenth Circuit rejected such a diluted standard:

> The requirement of knowledge in this context may be satisfied under a recklessness standard by the defendant's *knowledge* of a fact that was so obviously material that the defendant *must have been aware* both of its materiality *and* that its non-disclosure would likely mislead investors.

264 F.3d at 1261 (emphasis added). The Tenth Circuit would dismiss Plaintiffs' complaint.

III. This Case Is The Appropriate Vehicle To Resolve The Circuit Split Over The Statutory Requirement That Plaintiffs Plead The Factual Basis For Allegations Made On Information And Belief

Plaintiffs must set forth "all facts" that support each allegation pled on information and belief. This critical requirement of § (b)(1) permits courts to evaluate at the outset

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7. The Second Circuit also refused to consider facts alleged by Plaintiffs that undercut their own claim. Most notably, the Second Circuit ignored Plaintiffs' allegation that on November 27, 1996, Scholastic agreed to a $36.1 million, 3½-year contract to acquire dozens more *Goosebumps* books. L. 32 (¶ 67); Pet. App. 37a. The "most plausible" inference to be drawn from Scholastic's execution of this contract is that less than two weeks later — at the start of the alleged class period — Scholastic did not know of a material negative trend in *Goosebumps* sales.

whether allegations are based on facts and reliable sources or mere speculation. Section (b)(1) provides an important foundation for the scienter analysis required in § (b)(2). Unsupported allegations based solely on information and belief cannot give rise to a strong inference of scienter.

The First, Sixth, Eighth and Ninth Circuits demand that complaints specify the source and basis for allegations pled on information and belief. *See FTP Software*, 194 F.3d at 194 ("[T]his court has required plaintiffs who bring their claims on information and belief to set forth the source of the information and the reasons for the belief."); *In re Comshare Inc. Sec. Litig.*, 183 F.3d 542, 553 (6th Cir. 1999) ("[T]heir allegations rest on mere 'information and belief,' and cannot support a strong inference of scienter."); *Green Tree*, 2001 U.S. App. LEXIS 22921, at *65-66 ("[O]ur practice under Rule 9(b) of requiring disclosure of facts relied on for pleadings based on information and belief should obviously be continued under the Reform Act."); *Silicon Graphics*, 183 F.3d at 985 ("[A] plaintiff must provide, in great detail, all the relevant facts forming the basis of her belief.").

The Second Circuit, however, did not require Plaintiffs to identify the basis for any of their allegations against Petitioners, all of which they pled on information and belief. For example, Plaintiffs alleged that Scholastic had access to detailed sales data prepared by its indirect customers and therefore knew or should have known of an alleged negative sales trend. But Plaintiffs never claimed they had seen any documents that supported these allegations or spoken with anyone who had. Nonetheless, the Second Circuit "assum[ed] plaintiffs' allegations to be true." Pet. App. 22a. Plaintiffs' only response to this clear circuit split is to argue that their allegations were "based on a variety of reliable sources quoted or referred to in the Complaint." BIO 17. But they do not (and cannot) point to any support for this claim in their complaint.[8]

8. The allegations that the Second Circuit found "the most egregious" do not satisfy the basic requirement that a fraud claim identify (Cont'd)

The Second Circuit also accepted unsupported allegations that were not pled with particularity. Thus, the court credited Plaintiffs' claim that Scholastic prepared monthly "Director's Books" that "analyzed trade sales data and provided commentary on sales trends." App. 13a. In reality, Plaintiffs merely "identified" these reports. They did not plead their contents — not one number or statistic. And the Second Circuit did not require Plaintiffs to provide this information. Instead, it drew an inference "of the nature of the reports" from other unsupported allegations in the complaint. Pet. App. 16a.[9]

(Cont'd)
the challenged statements with particularity. App. 24a; *see* 15 U.S.C. § 78u-4(b)(1). On January 31, 1997, Merrill Lynch reported that "channel checks as well as discussions with [Scholastic's] management suggest that there has not been a surge in book returns." App. 41a. On February 25, Merrill Lynch issued another report that stated, "Before we upgraded the stock three weeks ago, management indicated that returns were running at normal levels and we received similar guidance even more recently." L. 34 (¶ 71). Plaintiffs did not specify what anyone at Scholastic actually said in these alleged conversations. Nonetheless, the Second Circuit sustained a fraud claim based on an analyst's statements about unspecified "suggest[ions]," "indicat[ions]" and "guidance" received from an unknown member of Scholastic's management at an unknown time under unknown circumstances. A court cannot draw a "strong inference" that statements were made with fraudulent intent if the actual statements are not identified.

9. The Second Circuit accepted numerous other unsupported allegations pled on information and belief that were similarly vague and conclusory. With respect to sales, the court ignored Plaintiffs' admission that Scholastic's business was seasonal according to the school year, which rendered the bulk of Plaintiffs' allegations meaningless because they did not provide sufficient information to make the appropriate comparison of one period to the same prior year period. Most of Plaintiffs' allegations regarding returns were also imprecise. These included allegations that Toys R Us returned "an unusually high amount" of *Goosebumps* books in December 1996 and that returns from a distributor, whose market share Plaintiffs never identified, "began to rise to unprecedented levels" in November and December 1996. Pet. App. 13a,

(Cont'd)

In *Silicon Graphics*, the Ninth Circuit dismissed a similar claim relating to negative information allegedly contained in shipment reports distributed to senior management. The court recognized that every large corporation produces numerous internal reports and, therefore, all plaintiffs could easily allege that their claims would be supported by "negative internal reports." 183 F.3d at 988. To prevent such abusive claims from proceeding to discovery, the Ninth Circuit required plaintiffs to specify the contents of such reports:

> We would expect that a proper complaint which purports to rely on the existence of internal reports would contain at least some specifics from those reports as well as such facts as may indicate their reliability . . . [I]n the absence of such specifics, we cannot determine whether there is any basis for alleging that the officers knew that their statements were false at the time they were made — a required element in pleading fraud.

Id. at 985.

By failing to enforce the Reform Act's requirements, the Second Circuit permitted Plaintiffs to make unsupported, generalized allegations and then engage in discovery to search for facts that might support their claims. Congress enacted the Reform Act to eliminate just this type of abusive "fraud by hindsight" claim. H.R. Conf. Rep. No. 104-369, at 31-32, *reprinted in* 1995 U.S.C.C.A.N. 730, 730-31.

CONCLUSION

Petitioners respectfully submit that the Court should grant a writ of certiorari to review the important issues of federal securities law presented in this case.

(Cont'd)

14a. And Plaintiffs acknowledged that Scholastic did not receive returns information for January 1997 until early February. L. 30 (¶ 58). As the district court correctly found, these allegations are too vague to establish a trend that Scholastic should have disclosed before February 1997.

Respectfully submitted,

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